

**Module J**

**IRC section 146 - Volume Cap**



# Module J

## IRC section 146 - Volume Cap

### Overview

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#### Introduction

Modules E through I discussed qualified private activity bonds. According to IRC section 141(e), to be considered a “qualified bond,” an obligation must:

- meet the appropriate specific requirements of IRC sections 142 through 145,
- meet the applicable requirements of IRC section 146, AND
- meet the applicable requirements of each subsection of IRC section 147.

Once an issue has met the requirements of the specific section under which it is described (IRC sections 142 through 145), the issue must still meet the volume cap requirements of IRC section 146, if applicable, AND comply with the applicable provisions of IRC section 147.

Module J discusses the volume cap, while Module K covers the requirements of IRC section 147.

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#### Current Regulations

Current regulations (Treas. Reg. Sections 1.103(n)-1T through -7T) for the volume cap still reflect the provisions of section 103(n) of the 1954 Code, and have NOT been updated to incorporate changes made by the TRA 1986.

Transitional rules relating to the volume cap are in Sections 1312(b)(3), 1313(a), 1313(b)(5), and 1315 of the TRA 1986.

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## Overview, Continued

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### Objectives

At the end of this module, you will be able to:

- Define and differentiate between the terms “volume cap” and “state ceiling.”
- Identify the types of bonds which are subject to the volume cap.
- Explain how the volume cap is computed.
- State the consequences of exceeding the volume cap.
- Determine if a proper election has been made to carry forward unused volume cap.
- Describe procedures that can be used to verify if the bonds have met the volume cap requirements.

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### Definition of “State Ceiling”

The “state ceiling” is the maximum amount of tax-exempt private activity bonds that can be issued by all of the authorized issuers within a state for the calendar year. Each state has one state ceiling.

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### Definition of “Volume Cap”

The “volume cap” for any issuing authority is the maximum amount of tax-exempt private activity bonds that may be issued during the calendar year. For purposes of the volume cap, issuing authorities of each state are divided into two groups:

- the State and all of its authorized agencies, AND
- all other issuing authorities.

Therefore, there are many volume caps within each state. If any bond added to the amount of tax-exempt private activity bonds issued in that calendar year exceeds that issuer’s volume cap, that issue is taxable.

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## Overview, Continued

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## Bonds Subject to the Volume Cap

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### **Only Certain Private Activity Bonds are Subject to the Volume Cap**

Volume cap applies generally to all qualified private activity bonds issued after August 15, 1986, including qualified enterprise zone facility bonds, except for the following:

- any qualified veterans' mortgage bond,
- any qualified 501(c)(3) bond,
- bonds used for airports, docks and wharves, and environmental enhancements of hydroelectric generation facilities (IRC sections 142(a)(1),(2), or (12)),
- 100 percent of any high-speed intercity rail facility bond (IRC section 142(a)(11)), IF OWNED BY A GOVERNMENTAL UNIT, (beginning January 1, 1994) AND
- 75 percent of any high-speed intercity rail facility bond (IRC section 142(a)(11)), IF OWNED BY OTHER THAN A GOVERNMENTAL UNIT.

IRC section 146(h)(1) provides an additional exception for any qualified private activity bond used for solid waste disposal facilities (IRC section 142(a)(6), if the property is OWNED BY A GOVERNMENTAL UNIT. IRC section 146(h)(2) provides the rules for determination of governmental ownership for purposes of IRC section 146(h)(1).

IRC section 146(f)(3)(A) provides that bonds issued pursuant to a valid carryforward election and within 3 years of the year in which the carry-forward closes shall not be included in the volume cap for the calendar year in which the bonds are issued.

IRC section 7871(c)((3)(iii) provides an exception for bonds issued by Indian tribal governments if at least 95 percent of the net proceeds are used for a manufacturing facility and certain other requirements are met.

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## Bonds Subject to the Volume Cap, Continued

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### Bonds Which Refund Post-1985 Bonds

Generally, IRC section 146(i) provides that current refundings of post-1985 bonds are not subject to the volume cap, as long as the issue amount is not greater than the outstanding amount of the refunded bond. Additional rules apply for qualified mortgage and student loan bonds.

Advance refundings of post-1985 governmental bonds are subject to the volume cap only if the provisions of IRC section 141(b)(5) apply or would have applied if the section applied to the issue. **(See IRC section 146(m)(2)).** If a proper election is made, this does not apply to the portion of a governmental bond used by a 501(c)(3) organization, if the proceeds used by the section 501(c)(3) organization, viewed as a separate issue, satisfy all requirements to be a qualified 501(c)(3) bond. **(See IRC section 141(b)(9)).**

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### Bonds Which Refund Pre-1986 Bonds

Section 1313(a)(1) of the TRA 1986 provides that current refundings of pre-1986 bonds will not be subject to the provisions of IRC section 146 if:

- the amount of the refunding bond does not exceed the outstanding amount of the refunded bond, AND
- the average maturity of the issue of which the refunding bond is a part does not exceed 120 percent of the average reasonably expected economic life of the facilities being financed with the proceeds of such issue, OR
- the refunding bond has a maturity date not later than the date which is 17 years after the date on which the qualified bond was issued.

Section 1313(b)(5) of the TRA 1986 provides generally, that certain advance refundings of pre-1986 bonds are subject to the provisions of IRC section 146 to the extent of the nongovernmental use of the issue, if more than five percent of the net proceeds of the refunded bonds were used for output projects.

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### Mortgage Credit Certificates

IRC section 146(n) provides that the volume cap is reduced for certain mortgage credit certificates.

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## Bonds Subject to the Volume Cap, Continued

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### Co-ordination with IRC Section 141(b)(5)

IRC section 141(b)(5) provides that a governmental bond will be treated as a private activity bond if:

- the “nonqualified amount” exceeds \$15 million, but is less than the amount needed to meet any of the private activity bond tests, AND
- the issuer does not allocate a portion of its volume cap to the issue in an amount equal to the excess of such nonqualified amount over \$15 million.

IRC section 141(b)(8) provides that the “nonqualified amount” is equal to the LESSER OF:

- the proceeds of the issue to be used for ANY private business use, OR
- the proceeds of the issue with respect to which there are payments (or property or borrowed money) described in IRC section 141(b)(2).

Note that this nonqualified amount must be less than the:

- 5 percent needed to satisfy the disproportionate use and/or payment tests,
- 10 percent needed to satisfy the private business tests.

### **Example**

County B issues bonds in the principal amount of \$300M on June 1, 1998. The bonds are used to construct an office building. A for-profit entity enters into a long-term lease for 7% (\$21M) of the building. The lease payments accounted for 7% (\$21M) of the debt service.

IRC section 141(b)(5) provides that \$6M (only the EXCESS over \$15M) of these bonds must be allocated to the volume cap. (\$21M-15M)

If this \$6M is not properly allocated, then the entire bond issue would be considered to be taxable private activity bonds. (The issue could NOT be qualified private activity bonds, because the section 146 requirements would not be met.)

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## Bonds Subject to the Volume Cap, Continued

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**Co-ordination  
with IRC  
Section  
141(b)(5),  
continued**

**Example**

County E issues bonds in the principal amount of \$200M on June 1, 1998. On the issuance date, County E reasonably expects to use 100 percent of the bond-financed facility for its own use. In May 2006, County E leases 8.5 percent of the facility to Corporation X, a for-profit entity. The lease payments (\$17M) will be used to pay 8.5 percent of the debt service on the bonds. Now what? There has been a deliberate action and change of use, but not enough to cause the bonds to meet the private business tests. However, \$2M of the bond proceeds should have been allocated to the volume cap. Section 141(b)(5) requires that the bonds be treated as private activity bonds. However, Rev. Proc. 97-15 or the remedial action provisions of Treas. Reg. section 1.141-12 may be applied.

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**Qualified  
501(c)(3) Bonds**

Portions of a governmental bond used by 501(c)(3) organizations in excess of \$15M (and up to the permitted 5% private use portion) are not subject to the volume limitations, if certain requirements are met. **(See IRC sections 141(b)(5) and (9) and IRC section 146(m)(1).)**

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**Reporting  
Requirements**

Issuers are required to indicate the amount of a governmental issue allocated to the volume cap on Form 8038-G, Part VI, line 32. **(See Exhibit B-1.)**

Issuers of qualified private activity bonds are required to indicate the amount of volume cap allocated to the issuer on Form 8038, Part VIII, line 37. **(See Exhibit B-2.)**

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## Volume Cap, General Rules

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### Exceeding the Volume Cap

If a private activity bond issue added to the total amount of tax-exempt private activity bonds issued in a calendar year causes the volume cap to be exceeded, that bond issue will be taxable.

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### State Ceiling

The state ceiling limits the amount of tax-exempt private activity bonds which can be issued annually in each state. According to IRC sections 146(d)(1) and (2), **for calendar years after 1987**, this limit is equal to the greater of:

- \$150 million, or
- \$50 multiplied by the state's population.

For bonds issued **after August 15, 1986 but before January 1, 1988**, the limit is equal to the greater of:

- \$250 million, or
- \$75 multiplied by the state's population.

For bonds issued **before August 16, 1986**, the limit is equal to the greater of:

- \$200 million, or
- \$150 multiplied by the state's population.

For bonds issued **after 1998**, the state ceiling for any calendar years shall be the greater of:

- an amount equal to the per capita limit for the year multiplied by the state population, or
- the aggregate limit for the year.

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## Volume Cap, General Rules, continued

### Allocation of State Ceiling

Each state's ceiling is allocated among state issuers and local issuers as follows:

- 50 percent to state and its agencies authorized to issue on behalf of the state, AND
- 50 percent to local issuers and authorities within the state on the basis of relative populations.

However, according to IRC section 146(e), in certain circumstances, a state may provide its own allocation formula for allocating its bonds.

### Example

In 1998, State A's population consists of 11 million residents. The largest cities are City A with two million residents and City B with three million residents. The rest of the population resides in other smaller cities.

State A's ceiling is equal to the greater of:

- \$150M, OR
- \$50 multiplied by the total population ( $50 \times 11,000,000 = \$550M$ )

Since \$550M exceeds \$150M, State A's ceiling equals \$550M.

Both state issuers and local issuers are each allocated \$275M. Since City A (population \$2M) and City B (population \$3M) are considered local issuers,


they would compute their allocation as follows:

CITY A:  $2M/11M = .18 \times \$275M = \$49.5M$

CITY B:  $3M/11M = .27 \times \$275M = \$74.25M$

Together Cities A and B account for 45% of State A's total population. Therefore, they will receive 45% of the \$275M allocated to local issuers. Other cities will receive the other 55%.

The \$550M ceiling would be allocated as follows:

All State Issuers	\$275.	50.0%	 50%
City A	49.5	9.0%	
City B	74.25	13.5%	
Other issuers	151.25	27.5%	
Total	\$550M	100.0%	

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## Volume Cap, General Rules, continued

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**Special Rules  
Regarding  
Computation of  
Volume Cap**

IRC section 146(d)(3) provides special rules for allocations to constitutional home rule cities.

IRC section 146(d)(4) provides a formula for certain possessions of the United States, which allows them to base their volume cap on the cap for the state with the lowest population.

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**Location of  
Bond-financed  
Facility**

Generally, no portion of the state ceiling may be allocated to bonds the proceeds of which will be used to finance a facility located outside of the state.

**(See IRC section 146(k) for specific exceptions.)**

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# Elective Carryforward of Unused Volume Cap for Specified Purpose

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<b>General Rule</b>	IRC section 146(f) permits an issuing authority to elect to carry forward any unused volume cap for three years.
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<b>Specific Purposes Permitted</b>	<p>According to IRC section 146(f)(5), any excess volume cap must be assigned to one of the following purposes:</p> <ul style="list-style-type: none"><li>• qualified student loan bonds</li><li>• qualified mortgage bonds (or mortgage credit certificates),</li><li>• qualified redevelopment bonds,</li><li>• exempt facility bonds under section 142(a) and enterprise zone facility bonds (Treas. Reg. section 1.1394-1(m)(3)).</li></ul>
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## **Example**

County B has been allocated \$50M of the state's volume limitation for 1998. During 1998, County B issues \$40M of bonds. County B plans to build within the next 3 years a qualified residential rental project for which County B would like to issue \$10M in bonds. County B can elect to carry forward \$10M from 1998 for this purpose by filing Form 8328 by February 15, 1999.

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<b>Making the Election</b>	<p>This election is made by filing Form 8328 by the earlier of:</p> <ul style="list-style-type: none"><li>• February 15 following the year in which the unused amount arises, OR</li><li>• the date of issue of bonds issued pursuant to the carryforward elections.</li></ul>
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**(See Notice 89-12, 1989-1 CB 633 (Exhibit J-1) for more information about the above provisions and Exhibit J-2 for Form 8328 and instructions.)**

IRC section 146(f)(4) provides that the election, once made, is irrevocable.

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<b>Where to File Form 8328</b>	As of July 1998, these forms are filed with the Internal Revenue Service Center in Ogden, Utah. Prior to this time, these forms were filed with the Philadelphia Service Center.
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## **Elective Carryforward of Unused Volume Cap for Specified Purpose, Continued**

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**Transitional Rules**

Section 1315 contains two exceptions under which bonds issued after August 16, 1986 are not subject to the provisions of IRC section 146.

Section 1315(b) provides that bonds issued pursuant to a carryforward election under section 103(n)(10) of the 1954 Code are not subject to IRC section 146 if:

- the election was made before November 1, 1985, and
- the provisions of Act section 1312(a) are met.

Section 1315(c) provides that IRC section 146 does not apply to bonds issued with respect to any facility or purpose specifically described in Section 1315(d) if the bonds would not have been subject to section 103(n) of the 1954 Code.

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# Auditing Techniques

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## Calculation of the Volume Cap

It is the responsibility of each individual state (and US possession) to calculate and allocate the volume cap for its own bonds.

The Internal Revenue Service does publish resident population estimates in the Internal Revenue Bulletin on an annual basis. **(See Exhibit J-3 for Notice 99-10, 1999-6 I.R.B. 16.)** These figures are to be used by states to compute their volume cap limitations.

With respect to US possessions, Notice 94-16, 1994-1 CB 337 contains the most recent population figures. **(See Exhibit J-4.)**

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## Where to Find Volume Cap Data

IRC section 149(e)(2)(F) requires that documentation regarding volume cap be submitted to the Internal Revenue Service by the 15<sup>th</sup> day of the 2d calendar month following the close of the calendar year in which the bonds are issued. Since this requirement coincides with the Form 8038 filing requirement, usually the volume cap certification is attached to Form 8038.

The bond transcript should contain documentation from the state which shows that a portion of the volume cap has been allocated to the bond issue.

If this documentation is not contained in the bond transcript, or attached to Form 8038, the agent should request it from the issuer.

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## Auditing Techniques, Continued

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**State Records**      Each state is required to maintain a record of the volume cap limitation.

Check with the state officer of the following departments:

- Department of finance,
- Department of economic development,
- Industrial commission, OR
- Other department or commission that is finance or business/industry related.

Each state will have some information pertaining to all bond issues, such as:

- name and address of issuer, sometimes phone number,
- name and address of conduit borrower, sometimes phone number,
- amount of issuer,
- type of bond i.e. small issue, exempt facility, etc,
- purpose of issue,
- total cost of project (which may exceed bond amount.)

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**Governmental Bonds**      Although governmental bonds are generally NOT subject to the volume cap limitations, a portion of the bonds could be if:

- there is private use or private payment in excess of \$15M, AND
- the extent of private use or private payment is NOT enough to satisfy the private activity bond tests.

In this situation, the agent would need to verify that a portion of the volume cap has been allocated to the amount in excess of \$15M.

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# Summary

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## Review of Module J

IRC section 141(e) sets forth the requirements of qualified private activity bonds as:

- meeting the specific requirements of IRC sections 142 through 145,
- meeting the requirements of IRC section 146, AND
- meeting the applicable requirements of each subsection of IRC section 147.

Modules E through I discussed the specific requirements of IRC sections 142 through 145.

Module J discussed the volume cap requirements of IRC section 146. The most important points of this module are:

- Most qualified private activity bonds are subject to the volume cap, with some exceptions.
- Although governmental bonds are not subject to the volume cap, portions of them might be if over \$15M is from private or disproportionate use or private payments.
- Computation of each state's volume cap limitation and allocation are the responsibility of each state.
- Unused volume cap can be carried over for three years, as long as the carryover is for a specified purpose and the issuer is specified.
- Documentation regarding the volume cap should be included in the bond transcript, and attached to Form 8038.
- It is the agent's responsibility to verify that volume cap has been allocated if required.

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## Preview of Module K

Module K discusses other requirements of certain qualified private activity bonds that are contained in IRC section 147.

Qualified private activity bonds need to meet the appropriate subsections of IRC section 147 in order for the interest on the bonds to be tax-exempt.

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## Discussion Questions

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### Exercise 1

The state ceiling for State Z for 1996 is \$200M. City M, a local issuer within the state, and State Z itself are authorized to issue private activity bonds. Under the allocation formula provided by State Z, City M has a volume cap of **\$50M**. The balance of the state ceiling (**\$150M**) is allocated to State Z.

On June 1, 1996, City M issues a **\$75M** issue of private activity bonds. On September 1, 1996, State Z issues a **\$150M** issue of private activity bonds.

**Question:** Based on these facts, are the bonds issued by City M described in IRC section 103(a)?

**Question:** What effect do City M's bonds have on State Z's \$150M issue?

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### Exercise 2

City K issues bonds in the principal amount of \$100M. City K uses \$50M for its own purposes and loans \$50M to a 501(c)(3) organization to build an animal shelter.

**Question:** What portion, if any, of these bonds is subject to the volume limitations?

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## Discussion Questions, Continued

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### Exercise 3

In 1995, State Authority received an allocation of \$100M, which was 50% of the private activity volume cap reserved for the state under IRC section 146. At the end of the year, the Authority filed Form 8328, electing to carry forward \$80M of unused volume cap for the purpose of issuing qualified student loan bonds. In 1996, the State legislature passed legislation creating Corporation X to issue and oversee qualified student loan bonds. Corporation X wants to use State Authority's \$80M carryforward issue qualified student loan bonds in 1997.

**Question:** Can Corporation X use State Authority's carryforward to issue qualified student loan bonds?

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END OF MODULE J

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